

Internal Revenue Service
memorandum

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date: MAR 15 1988

to: Jim Kamman, Special Trial Attorney
International, District Counsel, Laguna Nigel

from: Director, Tax Litigation Division

subject: [REDACTED]
[REDACTED] Claim for Attorney's Fees

You requested advice on the following issues:

1. Whether petitioner is entitled to reasonable fees based on respondent's failure to concede the addition to tax pursuant to I.R.C. § 6651(a)(1)?
2. Whether petitioner is entitled to reasonable attorney's fees due to the failure of the respondent to timely consider the case?
 - a. Whether Appeals' failure to assign the case to an Appeals Officer within six months was substantially justified?
 - b. Whether Appeals' failure to refer the case back to the District for additional examination work prior to the expiration of nine months was substantially justified?

CONCLUSION

For the reasons set forth below we concur with your recommendation that petitioner's claim be conceded to the extent of \$[REDACTED], based upon the hazards of litigation.

FACTS

In [REDACTED] the accounting firm of [REDACTED] was a defendant in an action to enjoin its alleged interference with the internal revenue laws. This action was based on [REDACTED] a service provided by [REDACTED] to clients and [REDACTED]. The petitioner here, [REDACTED] formerly [REDACTED], is (or was) a client of [REDACTED] and claimed ITC and depreciation deductions on its [REDACTED] and [REDACTED] returns. It filed its original [REDACTED] return on [REDACTED]. Two formal extensions were sought and granted; therefore the [REDACTED] filing was timely.

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Prior to any audit, a waiver of the statute of limitations was sought from the taxpayer. The file indicates that the request was made in person (by our agent) of the "Operations Manager", but that this person, after phoning another person, stated the bank declined to sign an extension. The Chief Financial Officer of the taxpayer claims that he was never asked to sign an extension. The statutory notice of deficiency is dated [REDACTED]. It disallows all ITC and depreciation deductions for both [REDACTED] and [REDACTED]. It also asserts the addition to tax under § 6651(a) as to the [REDACTED] return. No examination was conducted before the statutory notice was mailed.

The taxpayer petitioned the Tax Court on [REDACTED]. The administrative file did not reach the District Counsel attorney before our Answer was direct-mailed to the Tax Court on [REDACTED]. There ensued a six-month delay, during which the administrative file was transmitted among Appeals Offices. On [REDACTED], the District Counsel attorney wrote a memo to the Chief of Appeals in the district, requesting an officer be assigned to consider settlement of the matter. An assignment was made on [REDACTED].

Because of lack of development of the case, on [REDACTED] [REDACTED], the case was referred back to Examination, so the taxpayer could substantiate its claimed ITC and depreciation. Throughout the rest of [REDACTED] and all of [REDACTED], the case has been in an examination phase. Currently, all the substantive issues have been settled; a settlement stipulation is on file with the Tax Court. The sole issue remaining is the award of attorney's fees under § 7430.

LEGAL ANALYSIS

The petition was filed on [REDACTED]. The appropriate statute is I.R.C. § 7430, added by Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, Sec. 292(a), 96 Stat. 324, 572-574, effective for actions commenced after February 28, 1983 and before December 31, 1985.

The Tax Court case governing these "pre-1986" petitions is Baker v. Commissioner, 83 T.C. 822, 827 (1984), vacated and remanded on another issue, 787 F.2d 637 (D.C. Cir., 1986). The Tax Court held that it would evaluate the government's position as to its reasonableness beginning with the institution of litigation, at the filing of the petition. Following Baker, supra, the Tax Court has held repeatedly that the Service's actions at the administrative level, before the filing of a Tax Court petition, are irrelevant. See Don Casey Co. v. Commissioner, 87 T.C. 847, 861, 862 (1987); cf. Ewing and Thomas,

P.W. v. Heye, 803 F.2d 613 (11th Cir., 1986); United States v. Balanced Financial Management, Inc., 769 F.2d 1440 (10th Cir., 1985).

Other courts disagree and hold that the position taken by the Service at the administrative stage is relevant to the reasonableness of the Service's position. Kaufman v. Egger, 758 F.2d 1 (1st Cir., 1985), Powell v. Commissioner, 791 F.2d 385 (5th Cir., 1986). In Sliwa v. Commissioner, Docket No. 86-7432, filed February 12, 1988, the Ninth Circuit has adopted this position, and holds that the conduct of the Service at the administrative stage of the case is relevant to a determination of whether the Service has acted reasonably.

In Sliwa, the taxpayer divorced her husband, a confessed embezzler. As part of her divorce settlement the couple's residence was deeded to Sliwa, but the deed was technically invalid under state law. The Service, claiming that this technical fault rendered the invalid deed a fraudulent conveyance by the former husband, attempted to attach liens on the property. Sliwa filed a District Court suit to quiet title, in which she claimed innocent spouse status, and, subsequently, a Tax Court petition. The Service refused to concede the validity of her innocent spouse claim, and forced Sliwa to produce her bank records before conceding the Tax Court case. The Tax Court denied her claim for attorney's fees, holding that the Service was reasonable when it held Sliwa to her burden of proof.

On appeal, the Ninth Circuit held it would consider the pre-petition actions of the Service in determining reasonableness, but found the government's position reasonable because it had merely required the taxpayer to prove her innocent spouse status. Since the instant case is appealable to the Ninth Circuit, the Tax Court would be compelled to follow Sliwa, supra, and consider the reasonableness of both pre and post petition conduct. See Weight Watchers of Louisiana, Inc. v. Commissioner, T.C. Memo. 1987-456; Black v. Commissioner, T.C. Memo. 1987-239. Thus we must consider the position of the government from the inception of the case prior to the notice of deficiency.

In considering the position of the government through this matter, we conclude that substantial litigating hazards exist. Reasonableness is a question of fact to be determined from an examination of all the facts and circumstances, Baker, supra. An analysis of the instant facts reveals events which a court could find made the Service's position unreasonable. Here the taxpayer had two formal extensions of time to file. This information was peculiarly within the province of the District Director and he should have known, or should have been able to learn easily, that asserting the § 6651(a) delinquency penalty was incorrect.

Indeed, as you point out, the Service had the extensions of due date attached to the return when it prepared the notice of deficiency asserting the addition to tax.

As to the ITC and depreciation issues, the taxpayer has, in the ordinary case, the burden to show its entitlement to the deductions, New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Thus, in the ordinary course, the Service could properly demand proof of the taxpayer's entitlement to these tax benefits. However, this case did not follow the ordinary course of events.

First, this is not a complex case, factually or legally. At the time the statutory notice of deficiency was issued, the taxpayer had not had an opportunity to meet its burden of proof at the administrative level. The statutory notice was issued on the basis that the taxpayer had a preparer whose behavior was the subject of court action. We recognize that the statutory notice was issued in part because the statute of limitations appeared to be about to run. Nevertheless, that hardly constitutes an excuse to disallow all depreciation and ITC based upon the bad reputation of the tax preparer.

Further, this error was not promptly corrected. Only delay followed the filing of the petition, at a time when settlement negotiations ought to have been taking place. During this stage of the case, the administrative file seems to have wandered, without purpose, from office to office. Six months elapsed before an appeals officer was assigned; additional delay occurred in sending the case to Examination for investigation. As you pointed out in your memorandum, the courts have not responded kindly to lengthy delays in correcting pre-petition errors.

We believe that, in light of all the facts, the delay involved in the conduct of the entire case, the lack of an examination, and the apparent disregard of the contents of the return, the Service would be unwise to contest an award of attorney's fees. A court might easily hold that, under all the circumstances, our conduct was unreasonable when we issued the statutory notice of deficiency without conducting any examination and then failed to proceed with the case in a prompt and appropriate manner. The delay in processing this far from complex case, has apparently extended the conduct of litigation for one full year. Based on hazards of litigation, therefore, this case ought to be settled.

After a further review of the basis for the compromise offered, we agree with your appraisal that the \$ [REDACTED] award reflects the hazards here. While we are unaware of the billing

rate per hour, the overall cost seems appropriate for the time reasonably expended. The law does not compel the petitioner's concession of "audit exam fees" incurred in post-petition activities, and the reduction of costs therefor seems appropriate in return for the government's concession of the other costs. We grant permission to accept the offer made by the taxpayer of a stipulated award of \$ [REDACTED].

MARLENE GROSS
Director

By:


DANIEL J. WILES
Chief, Branch 3
Tax Litigation Division